IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

THURMAN ARNOLD
LOUIS EISENSTEIN
JULIUS M. GREISMAN
ARNOLD, FORTAS & PORTER
1229 19th Street, N.W.
Washington 6, D.C.
Attorneys for Petitioners

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CASES:

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the Tax Court (R. 253-280), Judge Kern dissenting (R. 280-281), is reported in 36 T.C. 22 (1961). The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-19a) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals (Appendix A, *infra*, pp. 20a-22a) were entered on July 6, 1962. The jurisdiction of this Court is invoked under 28 U.S.C., § 1254(1).

QUESTION PRESENTED

Three individuals were equal shareholders in two corporations which constructed and operated an apartment house development. During the taxable year involved the individuals sold their stock in the corporations. As part of the sale transaction, they also received distributions from the corporations. The question is whether the gains realized on the sale and distributions are taxable as ordinary income, rather than as capital gains, under section 117(m) of the Internal Revenue Code of 1939, relating to collapsible corporations.

STATUTES INVOLVED

The pertinent statutes appear in Appendix B, *infra*, pp. 23a-25a.

STATEMENT OF THE CASE

Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss are hereinafter referred to as the taxpayers.[1] For about 20 years they were jointly engaged in building various apartment houses and commercial properties. Each project was owned through a corporation and held as a long-term investment. The stock in two of the corporations was held for 10 years and

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[1] Diana Braunstein, Julia Neisloss and Lillian Neisloss are parties because they filed joint returns with their husbands. Benjamin Neisloss died on February 4, 1960 (R. 185), and his estate was duly substituted as a party.

15 years before it was sold. A third corporation realized a gain after three years. (R. 49, 78, 99-101, 103, 186-187.) Between 1943 and 1948 the taxpayers organized five corporations which built multiple dwelling projects financed under section 608 of the National Housing Act. The last of the five was completed on January 1, 1948. (R. 49, 78, 103, 187.) The taxpayers held their stock in one for over five years; in one for over nine years; and in two for about ten years. (R. 49, 78, 104, 187.) The taxpayers at no time held any of their numerous investment properties for a quick profit. (R. 49, 78, 99-101, 103, 186-187.) See also pp. 6-7, *infra.*

This case involves another FHA rental development known as Oakland Gardens. The taxpayers organized two corporations—Springfield Development Co., Inc. and Hill Development Co., Inc.—to build and operate Oakland Gardens. (R. 147, 189-190, 199, 215.)[2] The apartments became ready for occupancy from September, 1948 on, and the development was fully completed by July, 1949. (R. 45-46, 61, 67, 207, 220.)

During the period of construction and afterwards, there appeared to be a tremendous demand for apartments. The taxpayers' other FHA projects were fully rented, and they expected the same in Oakland Gardens. (R. 125, 163, 164.) In 1949, after construction was completed, the taxpayers could have sold Oakland Gardens for a quick profit which would have been taxable as a capital gain. (R. 127-128.) Section 117(m) was enacted on September 23, 1950. It was first recom-

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[2] Two corporations had to be formed, rather than one, because section 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743 (b)(3)(1952), barred loans beyond $5 million to any one mortgagor. Here the loans totalled over $6 million. (R. 326.)

mended to Congress on January 23, 1950. See Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 2-7 (1950).

Benjamin Neisloss, the managing partner, testified that throughout construction and for about ten months thereafter, the taxpayers intended to hold the property for long-term investment. (R. 125, 127-128.) He was corroborated not only by the 20-year history of the taxpayers' joint enterprises, but also by the facts that: (1) They never listed their stock with brokers; and (2) they flatly refused to consider any offers to buy their stock. One offer was made in March, 1950—about eight months after the project was completed. (R. 127-128, 169) Finally, Neisloss was further corroborated by the fact that the decision to sell was made only after it became apparent that the area was overbuilt, vacancies were running very high, and taxes and operating costs were sharply rising. (R. 128-135, 157-167.)

Both the taxpayers and the FHA made careful financial analyses of the development before it was built. (R. 195-196, 211-213, 328.) These studies indicated that the development would be self-liquidating, *i.e.*, that the revenues would be sufficient to amortize the mortgage loans and pay interest thereon, and also provide a satisfactory return. The FHA estimated that the annual return after debt servicing would be about $78,000. The taxpayers counted on a return of at least $45,000. (R. 196, 212, 265, 328.) These computations were based on assumed vacancies of 7 percent for both apartments and garages. (R. 195, 211.) The taxpayers anticipated hardly any vacancies at all because of their success in other FHA projects and the tremendous demand for apartments. (R. 163,

164.) However, toward the end of May, 1950, the taxpayers concluded that the development was threatened with an annual deficit of about $20,000, instead of a profit of at least $45,000. They decided to sell their stock before the situation deteriorated further. (R. 128-129, 133-135, 146-147, 157-158, 161-162, 166-167.)

The projected deficit was based on five items: a rental loss of $16,000 because vacancies were 9 instead of 7 percent (R. 128, 135)[3]; an extra cost of $10,000 for removing garbage, a service formerly rendered by the city (R. 129, 132-133, 135, 239, 267; Appendix A, *infra*, p. 10a)[4]; an additional cost of $10,000 for redecorating apartments vacated by tenants in violation of three-year leases (R. 134, 162)[5]; a further cost of $31,000 for free utilities to tenants to meet the new competition of neighboring projects (R. 239, 268; Appendix A, *infra*, pp. 10a-11a)[6]; and an increase of $30,000 in real estate taxes. (R. 70, 72-74, 129-132, 158, 239.)[7]

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[3] On an annual basis every 2 percentage points over the 7 percent projected by the FHA meant a loss of about $16,000 in rental income. (R. 128, 135.) The percentage reflects the ratio of the total vacancies to the total gross potential rents as stipulated by the parties. (R. 237.)

[4] The city discontinued the service in April, 1949. (R. 330.)

[5] The FHA had assumed that the apartments would be redecorated once every three years. (R. 57, 63, 134.) In the first five months of 1950 there were about 70 turnovers, requiring an outlay of $125 to $200 per apartment, or about $10,000 for redecorating. (R. 134.) As of May, 1950, the taxpayers expected this extra expense to continue. (R. 135.)

[6] This cost was estimated on the basis of projections made by Consolidated Edison Company. (R. 133-134.)

[7] The real estate taxes were increased beyond the FHA estimates by about $20,000 due to larger assessed values fixed in February, 1950; and by about $10,000 due to a record rise in tax rates predicted between March and May, 1950, and materializing in June, 1950. (R. 130-131, 238-239.)

In the latter part of May, 1960, the taxpayers were approached by brokers on behalf of two prospective purchasers. (R. 126-128, 167, 177, 243.) On June 9, 1960, the taxpayers entered into an agreement to sell their stock in Springfield and Hill. (R. 243.) The closing was scheduled for not later than September 30th. (R. 243-244.) At the insistence of the buyers' attorney, the agreement included a provision requiring the taxpayers to leave only small amounts of cash in the corporations. (R. 244.) On August 25, 1960, pursuant to this provision, Springfield and Hill distributed to the taxpayers all but nominal amounts of cash. (R. 46-47, 60-62, 119, 172-176, 243-246.)

The sale was not completed in September because one of the buyers refused to go through with the purchase. (R. 249.) Meanwhile the vacancies had steadily risen to 13 percent, representing an annual rental loss of $46,000 above vacancies as originally estimated. (R. 237.)[9] As a result, the taxpayers became more anxious to sell their stock. (R. 129.) After further delays by the buyers, the sale was finally consummated on November 12, 1960. (R. 249.)

Shortly before the sale in November the purchasers asked the taxpayers to make the necessary arrangements for providing the tenants with gas and electricity. (R. 133-134.) After the sale, Springfield and Hill provided utilities free to their tenants. (R. 250.) The two corporations continued to own the development. (R. 250.)

The taxpayers remained active in the operation of rental properties held as long-term investments. They continued to hold their stock in four other FHA proj-

[9] See note 3, *supra*.

erts. These four had been completed in [illegible], [illegible], and early [illegible]. (R. [illegible].)[9] In [illegible] the taxpayers, in their individual capacities, built a shopping center which they still owned at the time of trial in November [illegible]. (R. [illegible], [illegible].) In [illegible] they organized a corporation which built a large apartment house. The corporation still owned the building at the time of trial. (R. [illegible].) In [illegible] they remodeled apartments and built stores on property which they had held for about ten years. (R. [illegible], [illegible].)

Each taxpayer reported his gains attributable to the sale and distributions as long-term capital gains under sections 117(a) and 115(d) of the 1939 Code. (R. [illegible]; Appendix B, *infra*, pp. [illegible].)[10] The Commissioner determined that the gains were taxable as ordinary income on the ground that Springfield and Hill were collapsible corporations within section 117(m). The Tax Court sustained the Commissioner's determination. (R. [illegible].) Judge Kern dissented. He was the only judge who heard the testimony. (R. [illegible].) The Court of Appeals affirmed the decision of the Tax Court. (R. [illegible].)

[9] On November [illegible], 1949, the taxpayers sold their stock in a fifth project after holding it over four years. The sale was due to a very good offer. They had not been looking for a purchaser. As the Tax Court found, solely on the basis of Neidens' testimony, the sale was solicited by a broker on behalf of the buyer. (R. [illegible], [illegible], 104, 107.)

[10] Neither corporation had any accumulated earnings or profits at the time of the distributions, or any earnings or profits for its taxable year in which the distributions were made. (R. [illegible].)

REASONS FOR GRANTING THE WRIT

The gains realized on the sale and the distributions are taxable as long-term capital gains unless section 117(m) applies. Int. Rev. Code of 1939, §§ 115(d), 117(a). Section 117(m) was enacted in 1950,[11] and re-enacted as section 341 of the Internal Revenue Code of 1954. It provides that gain "from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation" is taxable as ordinary income. A collapsible corporation is defined as:

> "a corporation formed or availed of principally for the manufacture, construction, or production of property . . . with a view to—
>
> "(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and
>
> "(ii) the realization by such shareholders of gain attributable to such property."

I

The decision below is directly and admittedly in conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States v. Ivey*, 294 F. 2d 799 (1961), *rehearing denied*, 62-1 U.S.T.C. ¶9477 (1962).

Section 117(m) is a penal provision. As its legislative history discloses, it is narrowly concerned with corporations used to construct or produce property in order to obtain a special tax benefit for stockholders through a quick distribution or sale of stock. That benefit consists of having the usual profit earned on the

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[11] Revenue Act of 1950, § 212(a).

property taxed as a capital gain, where the same profit would be ordinary income if the corporation had realized it in the regular course of business or if the enterprise had been individually owned and operated. In short, section 117(m) was designed to prevent the conversion of what is normally ordinary income into a capital gain. A corporation is collapsible only if it was used for construction with a view to the realization of a capital gain, attributable to the constructed property, which would otherwise be realized as ordinary income. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950); Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 5, 20, 70-71, 139-141 (1950).

In *United States* v. *Ivey*, *supra*, the taxpayer similarly owned stock in a corporation which built an apartment house. The Fifth Circuit held that section 117 (m) does not apply to the profit realized on the sale of such stock, where the profit would have been taxable as a capital gain if the stockholders had owned the property individually. The statute, the court held, "does not penalize the taxpayer by converting his capital gain into ordinary income." It does not apply to taxpayers "who would have been entitled to capital gains treatment without incorporating." 294 F. 2d at 802. The opinion concludes that the statute "should not be read as applicable to cases where the shareholder's gain would be taxable as a capital gain had he realized it directly rather than through the corporate vehicle." Any attempt to apply it in that situation would impose an "irrational hardship." *Id.* at 803-805. On petition for rehearing, the Fifth Circuit reaffirmed its conclusion, after fully reconsidering the

authorities and arguments submitted by the Government. 62-1 U.S.T.C. ¶ 9477 (1962).

Under the *Ivey* decision Springfield and Hill were not collapsible corporations because they were not used as a means of converting ordinary business income into capital gain. The development owned by the corporations was property used in a trade or business. It was not property held primarily for sale to customers in the regular course of business. If the corporations had directly sold the development, the profit would have been a capital gain. Int. Rev. Code of 1939, § 117(j), re-enacted as Int. Rev. Code of 1954, § 1231. Similarly, if the taxpayers had individually owned the development and then sold it, the profit would have also been a capital gain. The taxpayers did not hold rental property for sale to customers in the ordinary course of business. (R. 97-101, 186-187; pp. 2-3, *supra.*) The sale of the stock instead of the assets produced the same capital gain.[12] The attempted application of section 117(m) converts what would otherwise be capital gain into ordinary income.

The court below fully recognized that under the *Ivey* decision, the profits involved here are taxable as capital gains. It squarely disapproved the *Ivey* decision in the following language (Appendix A, *infra*, p. 15a):

> "The taxpayers' final argument[13] is that § 117 (m) should not apply if the constructed apartment buildings would have produced capital gain

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[12] In this connection, the Tax Court specifically found, as the Commissioner stipulated, that the taxpayers' shares in Springfield and Hill were not property held primarily for sale to customers in the ordinary course of trade or business. (R. 250.)

[13] The court below refers to the taxpayers' reliance on the *Ivey* case as their "final argument." Appendix A, *infra*, p. 15a. Actually, it was the taxpayers' very first argument in their brief and oral presentation below.

on a sale by the taxpayers had no corporation been formed. We reject this argument which has, however, been recently accepted by the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (5th Cir. 1961) (2-1), rehearing denied with opinion, F. 2d (1962) (2-1).'"[14]

The express conflict between the Second and Fifth Circuits presents an important question of law which affects many taxpayers—especially those engaged in the construction of apartment houses, office buildings, and all other income-producing properties which qualify as capital assets. This question is a continuing problem under the 1954 Code as well as the 1939 Code. The *Ivey* case itself involved section 341 of the 1954 Code, which has replaced section 117(m) of the 1939 Code. The Senate Finance Committee has particularly indicated the need for an authoritative resolution of the problem. After carefully reviewing the problem, the Committee reported that the statute, as administered and applied, may have precisely the opposite effect from that intended. Instead of preventing the conversion of ordinary income into capital gain, it would convert capital gain into ordinary income. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32, 34 (1958). See also Statement of Chairman Mills of the Ways and Means Committee, 104 Cong. Rec. 17819 (1958).

II

The decision below presents another important issue for review which involves the basic reach and scope of section 117(m). That section does not apply unless the property was constructed "with a view to" the realization of a capital gain through a quick sale or distribu-

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[14] Actually the Fifth Circuit's decision on the issue involved here was unanimous—not "2-1."

tion. "Congress is here indicating *a state of mind* which must attend and give significance to certain action." (Italics supplied.) *Jacobson* v. *Commissioner,* 281 F. 2d 703, 705 (3d Cir. 1960). The special liability imposed by the statute depends on the subjective purpose which prompted the construction of the property. The decision below drastically departs from the statute by arbitrarily applying objective tests of liability instead of the subjective standard fixed by Congress. Under these objective tests the taxpayer's actual purpose or state of mind becomes irrelevant.

In applying its objective tests, the Court of Appeals expressly recognized that the evidentiary facts are not in dispute. Appendix A, *infra,* p. 5a, n. 4. The salient evidentiary facts include the following:

(a) The taxpayers made no attempt to sell their stock in 1949—when their profit would have been clearly taxable as a capital gain.

(b) For months after the project was completed, the taxpayers refused to consider a sale in response to offers to buy.

(c) Throughout the 20 years of their joint enterprise, the taxpayers never sold any of their rental properties for a quick gain.

(d) The taxpayers decided to sell in May, 1950, only after the area was overbuilt, vacancies became and remained excessive,[15] taxes were sharply rising, additional expenses were incurred for garbage removal and redecoration, and revenues had to be reduced by furnishing free utilities to tenants.

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[15] The Court of Appeals conceded that the vacancies were excessive and the vacancy rate was high. Appendix A, *infra.* p. 11a.

(e) The taxpayers still held four other FHA projects built before Oakland Gardens, when they sold their stock in Springfield and Hill.

(f) Between the decision to sell in May, 1950, and the eventual sale in November, 1950, the rental loss, on an annual basis, rose from $16,000 to $48,000.

On these facts Judge Kern, the only judge who heard the examination and cross-examination of the witnesses, found for the taxpayers. He concluded that their decision to sell was attributable solely to circumstances which arose after construction. (R. 280-281.) As this Court has stated, "Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them." *United States* v. *Yellow Cab Company*, 338 U.S. 338, 341 (1949). See also *Universal Camera Corp.* v. *Labor Board*, 340 U.S. 474, 496 (1951).

If the subjective test of probing the taxpayers' mind is applied, the above undisputed facts simply cannot be ignored. Yet the court below gave no weight to them. Most of these significant undisputed facts are not even mentioned in the opinion. Instead the court arbitrarily resorts to objective tests which, in its view, compel a decision against the taxpayers, regardless of what they actually intended or contemplated.

(1) The court states that the taxpayers did not invest substantial amounts of capital in the project, that the corporations made interest-free loans to the taxpayers, and that the underlying land of the development was owned by the taxpayers' wives. Then it concludes:

> "These facts—nominal capitalization, interest-free loans, and ownership of the land by the tax-

> payers' wives—while not necessarily inconsistent with Neisloss' testimony that the taxpayers intended to hold Springfield and Hill as long-term investments, lend little support to it." Appendix A, *infra*, p. 8a.

The objective nature of this test is evident from the court's own admission that the facts it selects are not inconsistent with the testimony. These facts, concededly, do not impeach Neisloss' veracity. But because they do not "support" his testimony, the court reasons that the testimony, however well corroborated, must be disregarded. In other words, the "objective facts" singled out by the court must be absent before it can be found that the taxpayer intended to hold property as a long-term investment.

It is, of course, true that the taxpayers did not select Springfield and Hill as the sole "long-term repositories of their wealth." Instead, they diversified their building investments, putting no more capital into any one project then the FHA deemed necessary, consistent with the FHA policy of expanding the construction of rental housing for veterans. The court's reasoning comes down to this: Since the taxpayers' testimony was not "supported" by the unbusinesslike policy of putting unnecessary capital into the project, their testimony may be disregarded. This is certainly an objective test. It has no relevance whatever to the taxpayers' actual subjective purpose or "view." Nor, even using the court's approach, has it any relevance to standard business judgment, which ordinarily regards diversification as a good long-term investment policy.

(2) The court does not dispute any of the items on the basis of which the taxpayers anticipated a deficit of

$20,000. But exercising its own business judgment, the court declares that the loss from vacancies and the cost of redecorating cannot be considered cumulatively with the conceded unexpected cost of free utilities. The court states:

> "Since Springfield's and Hill's failure to meet competition during these months (the first half of 1950) was probably a major cause of their high vacancy rate and since the taxpayers had decided to supply free utilities, the loss of revenues from excessive vacancies must be disregarded in predicting the projects' future net cash income. Similarly, once Springfield and Hill met competition the turnover of tenants would be reduced and the claimed redecorating costs *pro tanto* reduced. Thus the increased decorating costs and reduced rental income cannot be considered cumulatively with the cost of gas and electricity, but should be considered alternatively." Appendix A, *infra,* p. 11a.

Here the court has said that if the taxpayers had spent $31,000 annually for free utilities to tenants in order to meet competition, they would have eliminated undue vacancies in spite of the depressed character of the rental market. But this "business" judgment of the court can have no relevance in impeaching the business judgment of the more experienced taxpayers, who decided that the additional expense of $31,000 was a poor risk. In substituting its own judgment for that of the taxpayers, the court has plainly departed from the language and policy of section 117(m). That statute requires an evaluation of what was in the taxpayers' minds—not an evaluation of their business acumen.

The court's rigid rule of behavior is particularly arbitrary here. As of May, 1950, the corporations

would have had to spend $31,000 for utilities in an effort to restore $16,000 of income. Furthermore—and this the court below completely disregards—a substantial part of the rental loss was due to high vacancies in the garages. These vacancies were in no way related to the provision of free utilities. (R. 235-237.)[16] Finally, the court freely assumes that if utilities were supplied to tenants, competitors would become supine, excessive vacancies in apartments would automatically disappear, and redecorating costs would promptly decline. This is merely arbitrary conjecture in which the court has indulged on its own, without any evidence even as to the nature of the competing projects. An attempt to overcome business difficulties does not in the least mean that the effort will necessarily succeed.

(3) Apparently the court finally felt that its objective appraisal required more than its speculative presumption of what the taxpayers' view should have been. And so it bolstered its objective business judgment with still another such judgment. The court points out that each corporation showed a cash surplus for the period before and after May, 1950. "Taking the unexpected costs of utilities and garbage removal into account," the court states, "the project would still have been expected to produce an annual cash surplus." The court then concludes:

> "It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock

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[16] Garage vacancies average 57.8 percent a month in Springfield and 61.3 percent in Hill. (R. 236-237.) The FHA had estimated these vacancies at 7 percent. (R. 195, 211.)

> unless they had a previous view to its sale. Were the courts to permit any minor adversity to serve as the pretext for a previously contemplated disposition, the collapsible corporation provision would indeed have a narrow scope. Thus, we must distinguish between those events which truly motivate a change in existing plans and those which merely operate as a trigger." Appendix A, *infra*, p. 12a.

Even if the court's analysis is assumed to be valid—and it is not[17]—the court has again applied an objective test in lieu of the subjective standard established by the statute. The court holds that even though the project was in serious financial straits, the sale could not have been a business decision in response to the admitted difficulties. Taxpayers are thus arbitrarily presumed to have built a project "with a view to" its sale if they eventually sell before the corporate surplus is exhausted. They cannot choose the alternative of selling out, as businessmen commonly do when faced with developing difficulties. In other words, the honesty of a businessman's decision is impeached by disagreeing with his judgment. But the one and only question under the statute is whether the taxpayers in

[17] The Court of Appeals' computations of cash surplus are grossly misleading, for it ignores the conceded increase in real estate taxes, which the taxpayers likewise had "cause to expect" together with the cost of furnishing free utilities. See Appendix C, *infra*, p. 26a. As Appendix C shows, the surplus of three of the four years would be converted into a deficit if only the increased real estate taxes were taken into account.

Furthermore, at several points the court seems to suggest that the taxpayers have attributed the sale to an actual cash deficit. The taxpayers' case is not that a deficit had already materialized, but that it was imminent as of May, 1950—and that their decision to sell was based on their business evaluation of the situation at that time.

May, 1950 genuinely feared the onset of a deficit—not whether their judgment or solution should have been different. Section 117(m) "does not require the taxpayer to be an incorrigible optimist." *Cf. United States* v. *White Dental Co.,* 274 U.S. 398, 403 (1927). Nor does it in any way impinge on his exercise of judgment and discretion amid the inevitable vicissitudes of private enterprise.

The objective tests applied by the court below conflict with the subjective standard applied by the Third Circuit in *Jacobson* v. *Commissioner, supra,* at 705. They raise an important question of statutory construction which radiates far beyond this case. In our economy a businessman has no choice but to operate on the basis of his own predictions in the light of shifting contingencies. In business, as elsewhere, there are no certainties. "Every year if not every day we have to wager our salvation upon some prophecy based upon imperfect knowledge." Holmes, J., in *Abrams* v. *United States,* 250 U.S. 616, 630 (1918). Section 117(m) is not a license which enables the Commissioner to second-guess the business decisions of taxpayers through the wisdom of hindsight. He has more than enough to do without engaging vicariously in real estate ventures or some other enterprise. The opinion below makes it impossible for taxpayers to conduct their affairs in normal fashion, and without fear of harsh consequences, retroactively imposed, because their judgment will be questioned. The court's decision is particularly harassing in view of Treasury assurances to Congress that the statute would not penalize the customary business decisions of taxpayers. See Hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess. 139-141 (1950).

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted,

THURMAN ARNOLD
LOUIS EISENSTEIN
JULIUS M. GREISMAN
ARNOLD, FORTAS & PORTER
1229 19th Street, N.W.
Washington 6, D.C.
Attorneys for Petitioners

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 256-7-8—September Term, 1961

(Argued May 22, 1962 Decided July 6, 1962)

Docket Nos. 27146-7-8

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of BENJAMIN NEISLOSS, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Before: LUMBARD, *Chief Judge*, SMITH and MARSHALL, *Circuit Judges.*

Petition to review a decision of the Tax Court of the United States, Turner, *Judge*, holding that two corporations were collapsible corporations under § 117(m) of the Internal Revenue Code of 1939 and thus their shareholders recognized ordinary income on the sale of the stock of the corporations and the receipt of distributions from the corporations. 36 T. C. 22 (1961).

Affirmed.

THURMAN ARNOLD and LOUIS EISENSTEIN, Washington, D. C. (Julius M. Greisman and Arnold, Fortas & Porter, Washington, D. C., on the brief), *for petitioners.*

DAVID O. WALTER, Department of Justice, Washington, D. C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson and Harry Baum, Department of Justice, on the brief), *for respondent.*

LUMBARD, *Chief Judge:*

The taxpayers,[1] who had previously been active in constructing homes and apartment buildings, formed two cor-

porations in 1948 for the purpose of building apartment houses in a development called Oakland Gardens in Bayside, Queens County, New York, to be financed under § 608 of the National Housing Act.[2] The Federal Housing Administration (FHA) guaranteed mortgage loans to the two corporations which then built the proposed projects. Each corporation had an excess of mortgage loan funds remaining after the costs of construction had been paid. In 1950, the year following completion of construction, the three taxpayers sold their stock in both corporations at a profit and, as part of the sale transaction, received distributions which included the excess mortgage funds from the two corporations. The taxpayers reported the excess of the amounts they received—both on the distributions from the corporations and on sale of their stock—over their bases in the stock and the expenses of sale as long-term capital gains of $313,854.17 each. The Commissioner asserted that the two corporations were collapsible corporations under § 117(m) of the Internal Revenue Code of 1939[3] so that the

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1 Diana Braunstein, Julia Neisloss, and Lillian Neisloss are included in this proceeding only because they filed joint returns with their husbands, Benjamin Braunstein, Benjamin Neisloss and Harry Neisloss, respectively. The three husbands will herein be referred to as the taxpayers. Benjamin Neisloss is now deceased, his estate having been substituted as a party herein.

2 The taxpayers formed two corporations rather than one because § 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743(b)(3), prohibits loans beyond $5,000,000 to any one mortgagor.

3 § 117(m)—

"(1) Treatment of gain to shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) Definitions.—

"(A) For the purpose of this subsection, the term, 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

gains from the distributions and from the sale of the stock were ordinary income. In a decision which was reviewed by the full court, the Tax Court upheld the Commissioner with one judge dissenting. 36 T. C. 22 (1961). The taxpayers appeal, and we affirm.

The Taxpayers Had the Requisite View During Construction

According to § 117(m)(1) of the 1939 Code, gain from the sale or exchange of stock of a "collapsible corporation," which gain, but for § 117(m), would be long-term capital gain, is ordinary income. According to § 117(m)(2)(A), a corporation is a "collapsible corporation" if it is formed or availed of principally for the construction of property "with a view to * * * the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders,

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"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property.

* * * * *

"(3) Limitations on application of subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

"(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

"(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production. * * *"

[As added by § 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906.]

prior to the realization by the corporation * * * constructing * * * the property of a substantial part of the net income to be derived from such property" and "with a view to * * * the realization by such shareholders of gain attributable to such property." This "view" is present "whether such action [sale or exchange of the stock or distribution to shareholders] was contemplated unconditionally, conditionally, or as a recognized possibility." Treas. Reg. 111, § 29.117-11(b) (1953). The "view" to such sale or distribution must exist at some time "during construction." Treas. Reg. 111, § 29.117-11(b) (1953). See *Jacobson* v. *Commissioner*, 281 F. 2d 703 (3 Cir. 1960). But see *Glickman* v. *Commissioner*, 256 F. 2d 108, 110-11 (2 Cir. 1958) (dictum). Thus, if "the sale, exchange, or distribution is attributable to circumstances present at the time of * * * construction * * * the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of." Treas. Reg. 111, § 29.117-11(b) (1953). The regulations state that when a corporation's construction of property is substantial in relation to its other activities and its shareholders sell their stock or receive a distribution, thus recognizing a gain before the corporation has realized a substantial part of the net income from the property, these facts will ordinarily be sufficient, in the absence of other facts, to establish that the corporation is collapsible. Treas. Reg. 111, § 29.117-11(d) (1953).

In an attempt to satisfy their burden of proof that they did not have the requisite view to sale or distribution during construction the taxpayers make two main arguments. They contend that they intended the two corporations to be repositories for the accumulation of substantial estates for their families, and thus meant the corporations to be long-term investments. They further contend that the distributions and sales were attributable to an unanticipated decline in the profitability of the two corporations—a decrease in rent income and an increase in expenses—which occurred

after construction was completed. The Tax Court found that although the taxpayers may have been attempting to make profits, the facts were inconsistent with the use of the two corporations as a repository for these profits. The Tax Court also found that the facts did not bear out the taxpayers' claims that there was an unexpected decline in profitability after the completion of construction. We conclude that the Tax Court was not wrong when it found that the taxpayers had the requisite "view" prior to the completion of the two projects.[4]

Although Benjamin Neisloss testified that the two corporations were intended as a long-term repository for the accumulation of a large estate, the Tax Court need not accept the unsupported testimony of an interested party. See, e.g., *Hartman* v. *Commissioner*, 296 F. 2d 726, 727-28 (2 Cir. 1961); *Payne* v. *Commissioner*, 268 F. 2d 617, 621 (5 Cir. 1959); *Cohen* v. *Commissioner*, 148 F. 2d 336 (2 Cir. 1945). Thus it is necessary for us to examine the facts to see if they lend support to the taxpayers' contention.

Benjamin and Harry Neisloss were brothers active in various real estate construction enterprises since 1919. Benjamin Braunstein is an architect who had been associated with the other two since about 1930. Beginning in 1943 the three taxpayers organized and were equal stockholders in seven corporations which constructed multiple dwelling garden-type apartments financed under § 608 of the National Housing Act. After the passage of between one and ten years from the completion of these projects, the taxpayers sold their stock in the seven corporations in 1949, 1950, and 1953. This case concerns the distribution of cash and the sale of the stock of two of these corporations.

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[4] Although Judge Kern, the only judge to hear the oral testimony, dissented, the weight of the Tax Court's findings is not lessened because, as Judge Kern recognized, few of "the evidentiary facts are themselves in dispute," 36 TC at 88.

On March 31, 1948 Springfield Development Company, Inc., and Hill Development Company, Inc., were incorporated. Each of the three taxpayers purchased ten shares of the common A stock of each corporation for $1 per share. The FHA purchased 100 shares of each corporation's preferred stock for $1 per share. Thus the two corporations' total paid-in capital was only $260. The taxpayers and their other corporations made loans to Springfield and Hill which were repaid out of the mortgage loan proceeds. Although such a nominal capitalization is not wholly inconsistent with the taxpayers' claims that they intended Springfield and Hill as a repository for the accumulation of their estates, it certainly does not lend weight to their contentions.

Previously the taxpayers had obtained a commitment from the FHA for mortgage loan insurance for the two projects, which were in fact parts of a single overall development. The FHA's total estimated cost of the projects was $6,845,804 and the total mortgage insurance commitments were $6,101,600. Both corporations entered into loan agreements with the Bank of Manhattan Company to advance the amount of the FHA mortgage insurance commitment with 4% interest.

Springfield and Hill entered into contracts with the N. B. Construction Company, Inc., of which the three taxpayers were equal shareholders, for the construction of the projects.[5] Although these contracts specified a lump sum consideration, in practice Springfield and Hill merely reimbursed N. B. Construction for its costs.

Construction was begun in April 1948 and the various buildings were completed between September 1948 and June 1949. The costs of construction were less than had been estimated. Instead of contracting out the carpentry

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[5] This corporation was later succeeded by N. B. Construction Company, a partnership consisting of the three taxpayers, which completed the work. The corporation and partnership are regarded as interchangeable for purposes of this opinion.

and plumbing work, the taxpayers had their own men do the work, saving $80,000 on carpentry and $85,000 on plumbing and heating. A decline in the cost of lumber resulted in a saving of $50,000. There were other savings amounting to nearly $90,000 in title and recording expenses and legal and organizational expenses. Furthermore, the FHA cost estimates had included $599,741 as the total builder's and architect's fees to be incurred by Springfield and Hill. N. B. Construction acted as builder (in addition to doing the construction work) and Benjamin Braunstein acted as achitect for the two corporations without pay,[6] thus saving nearly $600,000 more.

Thus the mortgage loan proceeds exceeded the cash expenditures in constructing the two projects by more than $150,000. These excess funds were not used to prepay a part of the corporations' large mortgage indebtedness which was costing them 4% interest. Rather, these funds were loaned interest free to the taxpayers' other construction projects. Therefore, Springfield and Hill, far from accumulating the taxpayers' estate, were incurring uncompensated interest expenses while taxpayers' other corporations used the money to make a profit.

The land on which these projects were built was not owned by Springfield and Hill. In April and May 1947 Benjamin Neisloss entered into contracts to purchase the land for $120,000. On December 15, 1947, this land was conveyed to the wives of the three taxpayers who leased it to Springfield and Hill for 99 years at a total annual rental of $23,824, a rate which would repay the original cost in five years. In the FHA project analysis it was estimated that this land would be worth $595,600, five times its purchase price, after the projects were built. Although the legality or the propriety of this transaction is not questioned, it is

[6] Both of their contracts called for payment of fees in Common B stock. But shortly after entering these contracts both N. B. Construction and Braunstein released Springfield and Hill from their obligations to transfer the Common B stock.

evident that burdening the corporations with a substantial long-term rent obligation and shifting the benefit of the increase in value of the land due to the construction thereon from the corporations to the taxpayers' wives are not consistent with the taxpayers' claimed purpose to make Springfield and Hill long-term repositories of their increased estates.

These facts—nominal capitalization, interest free loans, and ownership of the land by the taxpayers' wives—while not necessarily inconsistent with Neisloss' testimony that the taxpayers intended to hold Springfield and Hill as long-term investments, lend little support to it. We turn now to the taxpayers' other contention, that the decision to sell was due solely to circumstances arising after construction which could not reasonably have been anticipated at the time of construction.

In making application for mortgage loan insurance the taxpayers submitted estimate of Springfield's and Hill's annual income and expenses. The FHA in making a project analysis made their own estimates. Rather than computing projected net income, the taxpayers and the FHA estimated net cash inflow, i.e., they started with estimated rent income and then deducted estimated cash expenses, estimated payments to the reserve for replacement of refrigerators, stoves, and equipment to be held by the mortgagee, and the amount of annual debt service (interest and principal payments and the cost of mortgage insurance), thus arriving at "Cash available for income taxes, corporate taxes, dividends and surplus." The estimates were as follows:

	FHA Estimate	Taxpayers' Estimate
Springfield	$53,925	$28,361
Hill	24,916	16,631
Total	$78,841	$44,992

The Tax Court found that in entering into the project the taxpayers were relying upon their own estimates and not on the FHA's higher predictions.

The taxpayers claim that decreases in rental income which were not expected when construction was completed and increases in operating expenses which were also unanticipated reduced the cash available for taxes, dividends and surplus to a deficit of $20,000 per year, and that the projects, far from being self-liquidating, would then have required the taxpayers to make annual contributions to the corporations' capital. This unexpected turn of events, rather than a previously held view to sale, the taxpayers argue, prompted them to decide to sell in late May 1950. The taxpayers compute the $20,000 annual deficit as follows:

FHA's estimated annual cash surplus		$78,841
Less:	Increased real estate taxes	$30,000
	Cost of garbage and rubbish removal	10,000
	Cost of furnishing free gas and electricity to tenants	31,000
	Decline in rental income	16,000
	Increased costs of redecorating	10,000
		$97,000
Cash deficit		$18,159

After examining all these factors which the taxpayers allege contributed to the purported cash deficit of nearly $20,000, we find that there was in fact no cash deficit and that the project, although not doing quite as well as the taxpayers had predicted, was earning a cash surplus. It is necessary to examine each of the factors which purportedly contributed to this nearly $20,000 annual cash deficit.

During early 1950 the New York newspapers predicted a large real estate tax increase. When the rate on Springfield's and Hill's property was fixed in June 1950 these predictions proved true. The FHA's and the taxpayers' estimates of real estate taxes and the actual 1950-51 tax in total for Springfield and Hill are as follows:

FHA's Estimates	$133,668
Taxpayers' Estimate	168,617
Actual 1950-51 real estate tax	163,663

The taxpayers, in calculating their $20,000 annual cash deficit, rely upon the fact that actual real estate taxes exceeded the FHA's estimate by $30,000. However, since the actual tax fell $5,000 short of the taxpayers' own estimate, they cannot claim that the amount of the real estate taxes was an unexpected factor.

In April 1949 the City of New York discontinued its service of garbage and rubbish removal. Thus the projects were forced to procure this service from a private contractor at a cost of approximately $8,500 a year which had not been anticipated at the time the estimates were made. The government argues that since the taxpayers were aware of this expense just before construction was completed in June 1949, to the extent that it produced a view to sell, this view was held "during construction." See *Glickman* v. *Commissioner*, 256 F. 2d 108, 111 (2 Cir. 1958). However, it has been argued that if a view to sell first arose after all the decisions affecting construction had been made and construction was largely completed, the view did not arise early enough to make the corporation collapsible. McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 61-62 (1953). Even accepting *arguendo* the latter position, we think that the Tax Court was correct. Thus we assume that this expense of $8,500 per year arose after construction was sufficiently near completion.

Springfield and Hill had not intended to provide free gas and electricity to their tenants. However, since various

competing projects did provide free utilities, Springfield and Hill had difficulty attracting and retaining tenants. Thus, by May 1950 the taxpayers decided that Springfield and Hill would have to meet competition and furnish free utilities. The cost of such a step was estimated at $31,000 per year. It appears that this expense was unexpected and might have reduced the projects' profitability unless the rents were increased slightly. Although the Federal Housing Regulations did not permit the taxpayers to increase rents without the district director's approval, Neisloss testified that the FHA entertained applications for increases if actual operating costs exceed the estimates. Of course, the competitive situation might have prevented an increase in rents and to that extent the cost of utilities would have reduced the net cash income.

The taxpayers also claim that the vacancy rates exceeded the 7% vacancies used by the FHA and the taxpayers in making their estimates. However, during the period in question, the first half of 1950, the taxpayers had not yet begun to supply free utilities. Since Springfield's and Hill's failure to meet competition during these months was probably a major cause of their high vacancy rate and since the taxpayers had decided to supply free utilities, the loss of revenues from excessive vacancies must be disregarded in predicting the projects' future net cash income. Similarly, once Springfield and Hill met competition the turnover of tenants would be reduced and the claimed redecorating costs *pro tanto* reduced. Thus the increased decorating costs and reduced rental income cannot be considered cumulatively with the cost of gas and electricity, but should be considered alternatively.

Taking the unexpected cost of utilities and garbage removal into account, the project would still have been expected to produce an annual cash surplus. The two corporations' actual results for the period before and after May 1950 bear out this conclusion. Before construction had begun the taxpayers estimated that Springfield's an-

nual cash surplus would be $28,361 and Hill's $16,631. The projects' actual cash surplus was as follows:[7]

	1950	1951
Springfield (Year ended Aug. 31)	$85,133	$27,351
Hill (Year ended Jan. 1)	8,978	11,596

It is difficult to believe that this small decrease, which is all the taxpayers had cause to expect, would have caused experienced real estate operators like the three taxpayers to sell their stock unless they had a previous view to its sale. Were the courts to permit any minor adversity to serve as the pretext for a previously contemplated disposition, the collapsible corporation provision would indeed have a narrow scope. Thus, we must distinguish between those events which truly motivate a change in existing plans and those which merely operate as a trigger.

The taxpayers argue that this analysis is altogether too objective since the question in issue is whether the taxpayers subjectively had a view to sell during construction. However, only by determining the objective facts and attempting to ascertain their effect on the taxpayers' minds can the court assess Benjamin Neisloss' self-serving testimony that the taxpayers had no view to sell until after construction had been completed.[8]

In late May 1950 the taxpayers were approached by brokers on behalf of prospective purchasers, and in early

[7] These figures were obtained by taking each corporation's net loss as reported on its federal income tax return, adding back non-cash depreciation expense and interest and insurance on the mortgage, and then subtracting the FHA's estimated annual payments for debt service (including interest and principal and mortgage insurance) and the annual payments to the reserve for replacement of equipment.

[8] McLean, Collapsible Corporations—The Statute and Regulations, 67 Harv. L. Rev. 55, 65-66 (1953); DeWind & Anthoine, Collapsible Corporations, 56 Colum. L. Rev. 475, 483 (1956).

June a contract was signed setting the price for all of Springfield's and Hill's stock at $400,000 subject to various plus and minus adjustments. Since the purchasers did not want to pay for a large amount of cash held by the corporations, Springfield and Hill increased the book value of its assets and declared dividends to the taxpayers totalling $555,000.[9] Since neither Springfield nor Hill had any accumulated earnings and profits at the time of the distribution or any earnings and profits for its taxable year in which the distributions were made, the distributions were not dividends for income tax purposes. Internal Revenue Code of 1939, § 115(a).[10] The final sale price of all the stock was $399,702. Taxpayers reported a total long-term capital gain on their 1950 income tax returns as follows:

Distributions from Springfield and Hill	$555,000
Selling price of Springfield and Hill stock	399,702
	$954,702
Less	
Cost of stock	$ 60
Expenses of sale	13,079
	$ 13,139
Gain	$941,563

[9] Since Springfield and Hill had loaned most of their excess cash to taxpayers' other enterprises, part of the $555,000 distribution was made by a set of bookkkeeping entries rather than through an actual cash distribution.

[10] Section 312(j) of the 1954 Code, applicable to distributions made after June 22, 1954, would have caused these distributions to be treated as dividends by increasing the corporations' earnings and profits by the amount of the excess of the FHA guaranteed loans over the adjusted basis of the buildings. However, under the 1939 Code, unless the collapsible corporation provision applies, the distributions would be treated as capital gains to the extent that they exceed the shareholder's basis. 1939 Code, § 115(d); *Commissioner v. Gross*, 236 F. 2d 612 (2 Cir. 1956), aff'g 23 TC 756 (1955).

Since we do not think that the Tax Court was wrong in concluding that the taxpayers had the requisite view to sale during construction, this gain is ordinary income unless for some other reason the collapsible corporation provision does not apply.

More than 70% of the Gain Was Attributable to the Constructed Property

Section 117(m) does not apply to this gain "unless more than 70 per centum of such gain is attributable to the property so * * * constructed." 1939 Code § 117(m)(3)(B). The taxpayers claim that more than 30% of the gain is due to retained rental income and that such gain is not "attributable to the property so * * * constructed." Since we find that less than 30% of the gain was due to retained income, we need not decide whether the regulations which broadly interpret "gain attributable to the property," apparently to include gain attributable to retained rental income, Treas. Reg. 111, § 29.117-11(c)(3), are valid. Compare *Spangler* v. *Commissioner*, 278 F. 2d 665, 670-71 (4 Cir. 1960), cert. denied, 364 U. S. 825 (1960); *Bryan* v. *Commissioner*, 281 F. 2d 238, 241 (4 Cir. 1960), cert. denied, 364 U. S. 931 (1961) (upholding the regulation), with McLean, *supra* note 8, at 79-80; DeWind & Anthoine, *supra* note 8, at 516; Anthoine, Recent Developments in Collapsible Corporations, New York University 14th Annual Institute on Federal Taxation 761, 782 (1956) (rejecting the regulation).

Springfield and Hill reported net losses on their income tax returns for the period that the taxpayers held their stock. However, in computing the amount of rental income that the two corporations accumulated, the taxpayers ask us to exclude two classes of deductions taken by the corporations on their income tax returns. But even if we agree with them as to the first, depreciation, which is a non-cash expense, the taxpayers' argument falls short. The monthly payments to the mortgagee for replacement of equipment

should then be regarded as coming out of operating revenues. The replacement of existing equipment is a prerequisite to continued operations. Therefore, we reject the taxpayers' claim that payments to the reserve for replacement should be treated as coming pro rata from the excess mortgage proceeds and the accumulated rental income. And we disagree with the taxpayers as to the second, interest and real estate taxes incurred during construction. Since the corporations chose to deduct these expenses on their income tax returns, we regard them as having been made out of operating income rather than out of the excess mortgage proceeds as the taxpayers argue. Consequently, less than 30% of the gain was due to accumulated operating income.

Section 117(m) Applies Even if Sale of the Corporate Assets Would Have Produced Capital Gain Had No Corporation Existed

The taxpayers' final argument is that § 117(m) should not apply if the constructed apartment buildings would have produced capital gain on a sale by the taxpayers had no corporation been formed. We reject this argument which has, however, been recently accepted by the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (5 Cir. 1961) (2-1), rehearing denied with opinion, —— F. 2d —— (1962) (2-1).[11] The argument goes as follows:

If a taxpayer who is engaged in a trade or business constructs an asset which he holds primarily for sale in the ordinary course of his trade or business, any gain from the sale of the asset is ordinary income. 1939 Code § 117 (a)(1)(A), (j)(1). Before the collapsible corporation provision was passed, a taxpayer could have formed a corporation to construct the asset and upon sale of the corpora-

[11] See also *Honaker Drilling, Inc.* v. *Koehler*, 190 F. Supp. 287 (D. Kan. 1960), where the district court utilized this argument to find that the corporation was not availed of with the requisite view.

tion's stock recognized capital gain instead of the ordinary income he would have received had no corporation been used. Therefore, the taxpayer argues, the collapsible corporation provision was enacted to give the taxpayer ordinary income on the sale of the stock just as he would have had ordinary income on the sale of the asset, and if the taxpayer, had he constructed and sold the asset himself, would not have had ordinary income on its sale, the collapsible corporation provision should not apply.

The collapsible corporation provision as literally written applies regardless of whether the assets constructed by the corporation would have produced capital gain or ordinary income if constructed and sold by the shareholder. Although this occasionally produces unwarranted taxation of capital gains as ordinary income, for the courts to rewrite the very complex legislation embodied in § 117(m) of the 1939 Code and its successor, § 341 of the 1954 Code, would produce even more confusion.[12]

The taxpayers in this case and the Fifth Circuit in *Ivey* assume that the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself. However, the legislative history discloses that § 117(m) has another major purpose. H. R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950); H. R. Rep. No. 586, 82nd Cong., 1st Sess. 25 (1951); Sen. Rep. No. 781, 82nd Cong., 1st Sess. 33 (1951). See also DeWind & Anthoine, *supra* note 8, at 475-77 (1956); Note, Legislative Response

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[12] The commentators have generally assumed that the collapsible corporation section would be literally interpreted by the courts. See, e.g., DeWind & Anthoine, *supra* note 8, at 487, 508-09, 533; Anthoine, Collapsible Corporations; 1957 Developments, New York Univ. 16th Annual Institute on Federal Taxation 659, 661 (1958); 3B Mertens, Federal Income Taxation § 22.64, p. 271; Mertens, Federal Income Taxation, Code Commentary, § 341(b)(3): 1; Bittker, Federal Income Taxation of Corporations and Shareholders 309-10 (1959).

to the Collapsible Corporation, 51 Colum. L. Rev. 361-62 (1951); Bittker, *supra* note 12, at 299-300. If an individual made a movie or constructed an apartment building, income received from the rental of the movie or building would be ordinary income. Thus some taxpayers formed a corporation to make the movie or construct the apartment building and then liquidated the corporation after the movie or the building was finished. On liquidation the shareholders were taxed at capital gain rates on the difference between their basis in the stock and the fair market value of the movie or apartment building, but the shareholders' basis in the movie or apartment building was stepped-up to fair market value. The shareholders could then rent out the movie or apartment building and amortize or depreciate their stepped-up basis against rental income. Congress enacted § 117(m) to make the shareholders' gain on liquidation ordinary income rather than capital gain. If an individual had made a movie with the intention of renting it, he would have capital gain on a subsequent sale since it would not have been held primarily for sale to customers in the ordinary course of his trade or business. Therefore, the collapsible corporation provision was intended to apply to some cases when the asset if sold by the taxpayer would have produced capital gain. However, if the *Ivey* decision is applied where a movie is made by a corporation which is then dissolved, the collapsible corporation provision will have no application to the basic fact situation which prompted its enactment.

Of course, this difficulty could be remedied by interpreting the *Ivey* decision as applicable only to sales of stock and not to liquidations. Thus, when the stock of a corporation is sold, it would not be collapsible if the underlying assets would have produced capital gain had no corporation been used, but when a corporation is liquidated, it would be collapsible regardless of whether the underlying assets would have produced capital gain had no corporation been

formed. However, since Congress chose to use a single statute to deal with both types of cases, it seems unwise for the courts to create the additional complexities inherent in such a two-fold interpretation. In 1958 Congress, in fact, adopted slightly different tests for collapsibility on liquidation and on sale of stock. Compare 1954 Code § 341 (e)(1), with 1954 Code § 341(e)(2), (4). See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 33-34 (1958). The multiplicity of detailed rules which this dual statutory test necessitated make it manifest that such an approach should not be effected by judicial decision.

Moreover, even as applied to the sale of stock situation, the *Ivey* decision departs from the Code's consistent framework for taxing collapsible corporations. According to the opinion denying a rehearing in *Ivey*, —— F. 2d —— (1962), if all the literal requirements of § 117(m) of the 1939 Code or its successor, § 341 of the 1954 Code, are satisfied, the court should disregard the shareholders' holding period for their stock and treat the shareholders as if they had owned the corporation's assets directly. Thus, any assets which the corporation has acquired within six months and which would be capital assets in the shareholders' hands will produce short-term capital gain while those held longer than six months will produce long-term capital gain. Regardless of the theoretical wisdom of this approach, it has no basis in the collapsible corporation provision which Congress has enacted. One of the clear policy decisions embodied in § 117(m) and its successor is the treatment of all or none of the gain as long-term capital gain, i.e., the refusal to split the gain between long-term capital gain and ordinary income. See Cohen, Tarleau, Surrey & Warren, A Proposed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise—American Law Institute Draft, 54 Colum. L. Rev. 157, 173-74, 177 (1954); *Commissioner* v. *Kelley*, 293 F. 2d 904, 912-13 (5 Cir. 1961).

Furthermore, regardless of how compatible with the statute the *Ivey* interpretation may have been previous to 1958, the addition of § 341(e) in that year makes *Ivey's* interpretation of the collapsible corporation provision anomalous. Although § 341(e) did not completely eliminate the conversion of capital gain into ordinary income by the collapsible corporation provision, it was designed to narrow the imposition of ordinary income treatment in an *Ivey* type of case where the shareholder would have recognized capital gain had he constructed and sold the asset without the use of a corporation. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958); Bittker, *supra* note 12, at 310-313-14. However, *Ivey* went further than § 341(e) in narrowing the scope of the collapsible corporation provision.[13] Therefore, if *Ivey* is correct, either § 341(e) is unnecessary or, if it is regarded as overruling *Ivey*, it expands rather than contracts the application of the collapsible corporation provision, clearly the contrary of what Congress intended. See Sen. Rep. No. 1983, 85th Cong., 2d Sess. 31-32 (1958).

Although the courts must often interpret sections of the Internal Revenue Code in light of their purposes in order to carry out Congressional intent, see, e.g., *Corn Products Refining Co. v. Commissioner*, 350 U. S. 46, 52, 53-54 (1955); *Gregory v. Commissioner*, 293 U. S. 465 (1935), when this would require the courts to extensively rewrite clear statutory language, the task of revision should be left to Congress, see, e.g., *Hanover Bank v. Commissioner*, —— U. S. —— (1962).

Affirmed.

[13] Section 341(e) was not applicable in *Ivey* since the operative facts had taken place before its enactment. Although § 341(e) had been enacted before the Fifth Circuit decided *Ivey*, the court did not discuss the statutory amendment.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixth day of July one thousand nine hundred and sixty-two.

Present:

Hon. J. Edward Lumbard,
Chief Judge,
Hon. J. Joseph Smith,
Hon. Thurgood Marshall,
Circuit Judges

BENJAMIN BRAUNSTEIN AND DIANA BRAUNSTEIN, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

By

VINCENT A. CARLIN
Chief Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

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Present:

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Chief Judge,
Hon. J. Joseph Smith,
Hon. Thurgood Marshall,
Circuit Judges

Estate of BENJAMIN NEISLOSS, Deceased,
JULIA H. NEISLOSS and RUSSEL NEISLOSS, Executors,
and JULIA NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

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UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixth day of July one thousand nine hundred and sixty-two.

Present:

Hon. J. Edward Lumbard,
Chief Judge,
Hon. J. Joseph Smith,
Hon. Thurgood Marshall,
Circuit Judges

Harry Neisloss and Lillian Neisloss, *Petitioners*,

v.

Commissioner of Internal Revenue, *Respondent*.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro
Clerk
By
Vincent A. Carlin
Chief Deputy Clerk

APPENDIX B

Internal Revenue Code of 1939:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(d) OTHER DISTRIBUTIONS FROM CAPITAL. If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

* * * *

(26 U.S.C. 1952 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.—(a) DEFINITIONS.—As used in this chapter—

(1) CAPITAL ASSETS. The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * * *

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing net income;

* * * *

(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.—

(1) Definition of Property Used in the Trade or Business.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . .

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, . . . exceed the recognized losses from such sales, exchanges, . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than six months. . . .

(m) [As added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] *Collapsible Corporations*—

(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) Definitions.—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

* * * *

(3) Limitations on Application of Subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

* * * *

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

* * * *

(26 U.S.C. 1952 ed., Sec. 117.)

APPENDIX C

The Court of Appeals sets forth the following cash surplus (Appendix A, *supra*, p. 12a):

	1950	1951
Springfield (year ended August 31)	$85,133	$27,351
Hill (year ended January 31)	8,978	11,596

These figures are quite misleading because they completely disregard impending real estate taxes.

In the case of Springfield the surplus for fiscal 1950 did not yet reflect the full impact of those taxes. The taxes for that year were only $22,724.76, as compared with the imminent burden of $112,324.50 for fiscal 1951. (R. 240.) The difference then, was $89,599.74. In short, even apart from the cost of free utilities, Springfield as of 1950 faced a deficit of about $5,000 due to additional taxes.

In the case of Hill the court also ignores impending real estate taxes. The taxes for fiscal 1950 were only $2,645.53 (R. 241), as compared with $51,339, the amount fixed by the city in June, 1950—five months after the end of that fiscal year. (R. 263.) As applied to fiscal 1950, the difference of $48,693.47 would have converted the surplus of $8,978 into a cash deficit of $39,715.47. Similarly, in fiscal 1951 the new taxes on Hill were not yet fully effective for the entire year. They were only $31,100.63 (R. 241) instead of $51,339. As applied to fiscal 1951, the difference of $20,228.37 would have converted the cash surplus of $11,596 into a cash deficit of $8,632.37.